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In the Supreme Court of the United States

OCTOBER TERM, 1959

No. 463

WILLIAM K. WARREN AND NATALIE O. WARREN, ET AL., PETITIONERS

v.

THE UNITED STATES

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINION BELOW

The opinions in the Court of Claims (Pet. App. 2a–11a) are reported at 171 F. Supp. 846.

JURISDICTION

The judgment of the Court of Claims was entered on April 8, 1959 (Pet. 7a). A motion for rehearing was overruled on July 13, 1959 (Pet. App. 1). The petition for certiorari was filed on October 12, 1959. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

In 1941 the taxpayers received overriding royalty interests in oil and gas leases in connection with the

sale of their stock in, and the liquidation of, a corporation. In the taxable years 1949 through 1952 they received the royalty income which accrued to them under their overriding royalty interests. The question is whether the royalty income is taxable as ordinary income subject to an allowance for depletion, rather than as capital gain from the sale or liquidation of their stock interests.

STATEMENT

Prior to May 5, 1941, the Corpus Christi Corporation held oil and gas leases on 8,782 acres of land in three counties in Texas. Some eighteen producing wells were located on 2,200 acres of the property; the remainder was undeveloped. The corporation also owned and operated a high pressure cycling plant which had been constructed to extract the saleable distillate from the wet gas and reinject the dry gas into the earth (Pet. App. 2a).

Of Corpus Christi's 5,000 shares of stock, the Chicago Corporation owned 1,250 and the taxpayers owned the other 3,750 shares. Faced with a problem of financing the development of the property, the taxpayers sought to dispose of their stock in Corpus Christi (Pet. App. 2a). On May 5, 1941, they accepted an offer by the Chicago Corporation; under the terms of the offer, Chicago Corporation was to pay the selling shareholders, for sufficient shares to bring Chicago's holdings to 80% of the stock, $163.63 per share plus an additional amount of cash. The amount of such additional cash depended upon the tax treatment of the proposed liquidation of Corpus Christi.

In addition, Chicago agreed to cause Corpus Christi to convey to each shareholder who sold his stock to Chicago an overriding royalty interest, measured by a specified fraction per share of stock, in the oil, gas and other minerals in and under and to be produced from the Corpus Christi leases [1] (Pet. App. 2a–3a).

The sale of the Corpus Christi stock was accomplished in May 1941 and Corpus Christi was liquidated shortly thereafter. The Chicago Corporation paid the taxpayers the agreed amount of cash and caused Corpus Christi to convey the overriding royalty interests to the taxpayers under the terms of the conveyances. The conveyances of the overriding royalty interests to the taxpayers were similar in terms (with an exception not material to this case) to instruments generally used in the oil and gas industry for conveying overriding royalty interests (Pet. App. 3a).

In the taxpayers' income tax returns for 1941, the year in which they sold their Corpus Christi stock and acquired the overriding royalty interests, they reported as long-term capital gain the excess of the cash paid to them by Chicago over what their Corpus Christi stock had cost them. They did not include in their capital gain any value for the overriding royalty interests which they received in the transaction, stating that those interests had no ascertainable market value. The Commissioner, however, placed a value of $1,035,000 upon the interests of all the

[1] In the oil and gas industry the term overriding royalty interest means a fraction of the working interest which by agreement is relieved of the expenses of development and production (Pet. App. 3a).

minority stockholders, and added proportionate parts of that amount to the capital gains of the taxpayers. The taxpayers paid taxes on these additional amounts of capital gain (Pet. App. 3a–4a).

For the taxable years 1949 through 1952, the years involved here, the taxpayers included in their returns their receipts from their overriding royalty interests as ordinary income and deducted the statutory 27½ percent depletion allowance. So far as appears, they had also treated their income similarly for the years 1941 through 1948. For the years 1949 through 1952 they filed timely claims for refund on the ground that the receipts from their overriding royalty interests were additional amounts received by them as part of the purchase price of the Corpus Christi stock which they sold to Chicago in 1941 and should therefore be taxed at capital gain rates (Pet. App. 4a).

The Court of Claims, with two judges dissenting, held that the plaintiffs were not entitled to have their receipts from their overriding royalty interests taxed at capital gain rates, regardless of whether in 1941, when the overriding royalty interests were received, such interests had an ascertainable fair market value (Pet. App. 4a–11a).

ARGUMENT

No basis for certiorari is presented. The narrow, technical issues involved lack general importance; there is no conflict of decisions; and, on the merits, the decision below is correct.

1. The taxpayers' royalty income is not taxable as capital gain; it was not derived from a capital transaction. The 1941 transaction, under which they received cash and overriding royalty interests for their

stock, was a closed transaction in 1941. That the value of the royalty interests may not have been subject to accurate estimate did not alter the character either of the transaction or of what the taxpayers received. And, as this Court has held, such royalty interests are property interests in the oil and gas in place. See, *e.g.*, *Palmer* v. *Bender*, 287 U.S. 551; *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U.S. 25. The income from oil and gas royalty interests is taxable as ordinary income, subject to a depletion allowance, rather than as capital gain. *Burnet* v. *Harmel*, 287 U.S. 103; *Palmer* v. *Bender*, *supra*; *Burton-Sutton Oil Co.* v. *Commissioner*, *supra*; *Anderson* v. *Helvering*, 310 U.S. 404; *Commissioner* v. *Southwest Expl. Co.*, 350 U.S. 308.

No exception from the general principle can be justified here on the ground that the royalty interests were received in exchange for other property and are a type of property or asset which was later *pro tanto* exhausted as the oil was taken out of the ground. Indeed, it is precisely because the owners of royalty interests are deemed to have an ownership, or capital, interest in the oil and gas in place that they are entitled to a depletion deduction, and that deduction, allowed concurrently with the extraction of the oil, compensates for the attendant loss in relation to the property or capital interest as such. See, *e.g.*, *Parsons* v. *Smith*, 359 U.S. 215.

2. The decision below involves no conflict with *Burnet* v. *Logan*, 283 U.S. 404. In that case the taxpayer, Edith Logan, owned stock in Andrews & Hitchcock Iron Company which in turn owned stock in Mahoning Ore and Steel Company. The latter

corporation owned a mining lease and by agreement among its stockholders apportioned ore among its stockholders according to their holdings. In 1916, Edith Logan and the other stockholders sold their stock in Hitchcock Iron Company to Youngstown Sheet and Tube Company which thereupon acquired the right to receive a portion of the mining production by Mahoning Ore and Steel Company. For this stock Youngstown paid cash and agreed to pay annually thereafter a sum equal to 60 cents for each ton of ore to which it became entitled by virtue of its stockholding in Mahoning. The Internal Revenue Service sought to tax to Edith Logan as gain in 1916 the cash plus the estimated value of the contract calling for subsequent payments. This Court held that the value of the contract could not be accurately estimated; that, consequently, the transaction could not be closed in 1916; that Edith Logan should pay no tax on income until she recovered a sum equal to the basis for her stock, and that thereafter she should report the subsequent payments as received.

Thus, *Burnet v. Logan* did not involve income derived from the operation of a mine. The Court was careful to point out (283 U.S., at p. 412) that it was "not dealing with royalties or deductions from gross income because of depletion of mining property."[2] The case dealt merely with the collections of subsequent payments in discharge of the purchase price

[2] Other courts have pointed out that the case has nothing to do with royalties or other income from the operation of mineral leases. *Smaltz* v. *McCaughn*, 5 F. Supp. 204, 205 (E.D. Pa.); *Commissioner* v. *J. A. O'Shaughnessy, Inc.*, 124 F. 2d 33 (C.A. 10th).

of property. Such payments were measured by production but were made in discharge of a personal covenant or obligation. Edith Logan was not the owner of a property interest in the mines. Her contract was with Youngstown, which had no interest in the mines. Thus, the instant case is readily distinguishable.

This distinction between gross income derived from an interest in minerals in place and collection of contingent installment payments was carefully observed in all the cases involving oil and gas transactions which are cited in Appendix G to the taxpayers' petition (Pet. App. 23a–25a). In those cases the courts held that *Burnet* v. *Logan, supra,* and the so-called open transaction doctrine were not applicable to income derived from the operation of oil and gas wells. In some of the cases[3] it was found that the taxpayer owned an economic or property interest in the oil and gas in place and was taxable on his royalty or oil payment income as ordinary income subject to the allowance for depletion. In other cases[4] it was found that the tax-

[3] *Columbia Oil & Gas Co.* v. *Commissioner*, 41 B.T.A. 38, 47–48, affirmed, 118 F. 2d 459 (C.A. 5th); *Dearing* v. *Commissioner*, 36 B.T.A. 843, affirmed, 102 F. 2d 91 (C.A. 5th) (value of oil payment there involved not ascertainable) *Gatliff* v. *Helburn*, 31 F. Supp. 495 (E.D. Ky.); *Reynolds* v. *McMurray*, 60 F. 2d 843 (C.A. 10th); *Smaltz* v. *McCaughn*, 5 F. Supp. 204 (E.D. Pa); *Boudreau* v. *Commissioner*, 134 F. 2d 360 (C.A. 5th) (value of the mineral interest fixed by the court).

[4] *Commissioner* v. *Garber*, 50 F. 2d 588 (C.A. 9th); *Edwards Drilling Co.* v. *Commissioner*, 35 B.T.A. 341, affirmed, 95 F. 2d 719 (C.A. 5th) (Board of Tax Appeals' opinion found contracts had a stated fair market value); *Commissioner* v. *Moore*, 48 F. 2d 526 (C.A. 10th), certiorari denied, 284 U.S. 620; *Hobbs* v. *Commissioner*, 26 B.T.A. 241; [illegible]*lson* v. *Commissioner*, 3 T.C. 596; *O'Donnell* v. *Commissioner*, 25 B.T.A. 956, affirmed,

payer was entitled to, or received, contingent payments measured by the product of oil and gas or other minerals, but had no economic or other property interest in the minerals in place. The other cited cases contain references to *Burnet* v. *Logan, supra,* but do not involve oil and gas or other mineral transactions and are irrelevant here.

3. The decision below is not in conflict with *Commissioner* v. *Carter,* 170 F. 2d 911 (C.A. 2d), and *Westover* v. *Smith,* 173 F. 2d 90 (C.A. 9th). Those cases involved the liquidation and collection of property in the form of contingent promises to pay money, whereas the present case involves the taxation of income produced from property owned by the taxpayers.

In *Commissioner* v. *Carter, supra,* the taxpayer, upon dissolution of a corporation, received all of its assets in surrender of her stock. Among the assets were 32 oil brokerage contracts which, it was stipulated, had no ascertainable fair market value. Each contract provided for payment to the corporation of commission on future deliveries of oil by a named seller to a named buyer. The contracts required no additional services to be performed by the payee and were subject to contingencies which made uncertain the amount and time of payment. The court held that collections under the contracts were taxable as

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64 F. 2d 634 (C.A. 9th), certiorari denied, 290 U.S. 699; *Reimer* v. *Commissioner,* 28 T.C. 85, affirmed, 260 F. 2d 337 (C.A. 8th); *Rocky Mountain Development Co.* v. *Commissioner,* 38 B.T.A. 1303. In *Boudreau* v. *Commissioner,* 134 F. 2d 360 (C.A. 5th), the value of the royalty interests was fixed and the tax was computed accordingly.

capital gain, reasoning that each payment decreased the value of the contracts, which would be exhausted with the final payment, and that, if the payments were treated as income, the distributee had no way to recoup his capital. The court distinguished this situation from cases (like the present one) where property, such as bonds and real estate, produces income, and pointed out (p. 913) that the taxpayer in that case had "no economic interest in the oil producing properties and therefore no right to depletion deductions."

Westover v. *Smith*, *supra*, is similar. There the taxpayer upon liquidation of a corporation, Quickwork Company, acquired a contract which entitled him to ten percent of the gross sales price of machinery to be manufactured and sold by Whiting Corporation, to which Quickwork Company had sold some patents. Owing to future business contingencies, there was no way of ascertaining its fair market value. The court held that collections under the contract should be treated as payments in exchange for the stock and taxed as capital gain.

Carter and *Westover*, *supra*, are therefore cases which, because of their facts, were held to warrant the application of an exception to the general rule which is inapplicable to the present case. Here the property involved is not just a contractual right to receive money in the future; it is an interest in real property. And, because of the difference in the type of property involved, the taxpayers' capital, represented by the value of the property in 1941 (in what-

ever amount) is recouped through the depletion allowance.[8]

CONCLUSION

The petition for certiorari should be denied.

Respectfully submitted.

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NOVEMBER 1959.

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[8] *Hoy* v. *Commissioner*, decided February 25, 1958 (1958 P-H T.C. Memorandum Decisions, par. 58,028), also relied upon by taxpayers (Pet. 7-9), is similar to the *Carter* and *Westover* cases. Rev. Rul. 58-402, 1958-2 Cum. Bull. 15, cited by the taxpayers for the proposition that the "open transaction doctrine" is well recognized by the Commissioner (Pet. 10), states the rule of the *Carter* and *Westover* cases—that contingent contracts may be subject to capital gain treatment—but emphasizes that it is only in rare and extraordinary cases that property will be treated as having no ascertainable market value. The ruling has no bearing on the manner in which income from income producing property is to be taxed, and especially not to oil and gas interests where the exact value of the property (or capital investment) is completely immaterial in computing the depletion allowance through which that value (or capital investment) is recovered.

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